DOW THEORY LETTERS INC.

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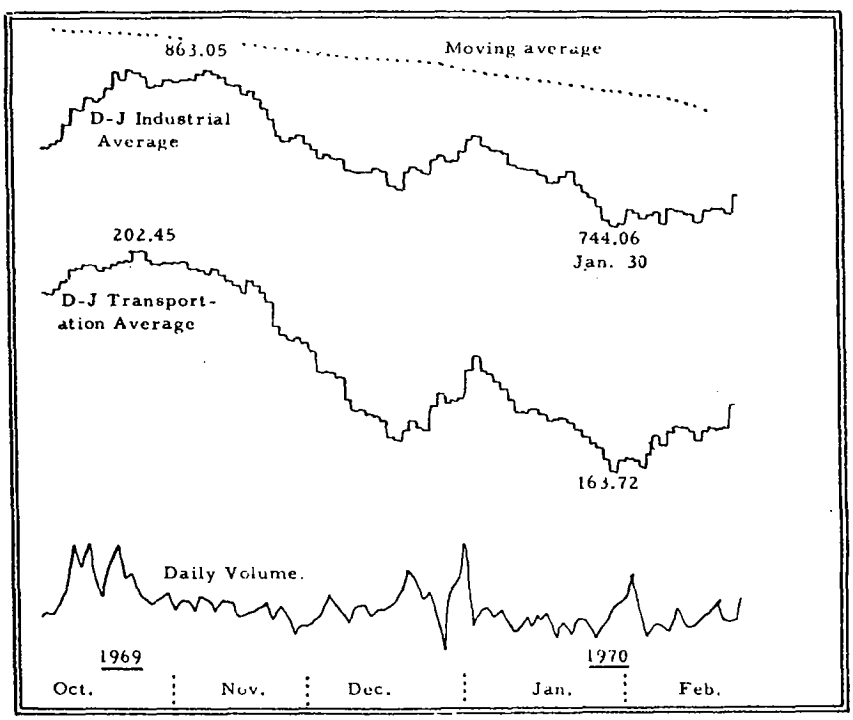
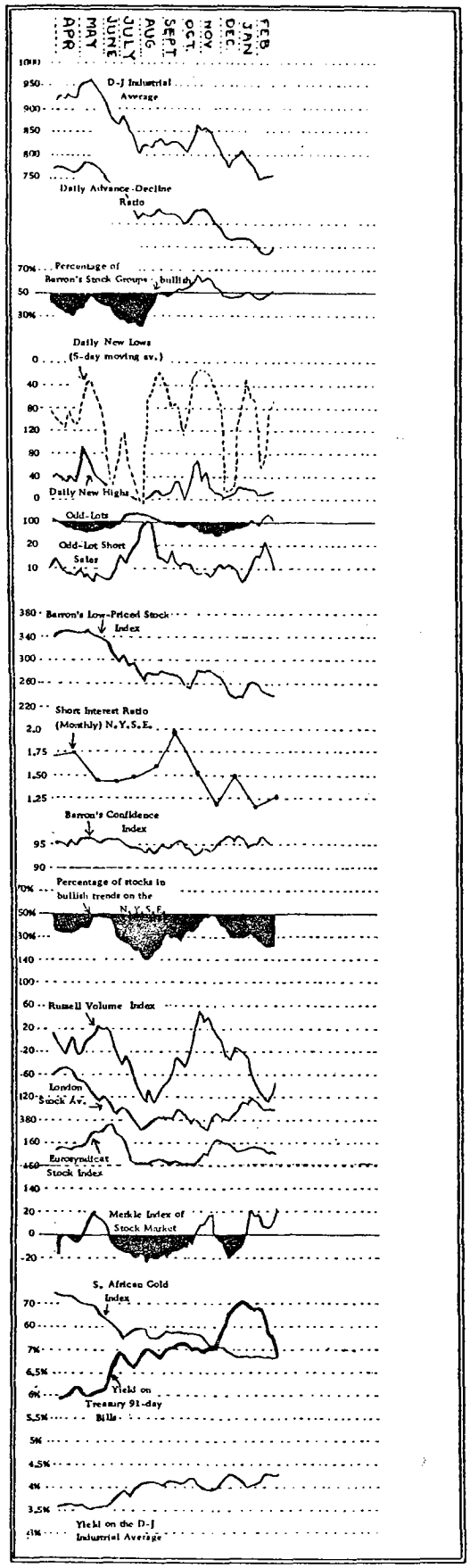
THE MARKET: The stock market collapse, taken from the December, 1968 high to the January 30, 1970 low lasted 14 months. It was the longest decline since the end of World War II. During that period the Dow Industrials lost 224 points while the advance-decline ratio gave up over 21 points. In comparison, during the drastic 1962 decline the Dow lost 199 points while the A-D ratio lost 14 points. During the first leg of the bear market in 1966, the Dow erased 251 points while the A-D ratio lost over 17 points. In other words, the decline in the Dow during 1968-70 was roughly comparable to any of the worst sell-offs since the late-1940's while the smash in the breadth index was considerably worse.

By almost any measurement of the past two decades, the market "should be exhausted" on the downside and ready for a substantial rally. And there's no question about it, almost every advisory organization I exchange services with has now given a "buy" signal, while many have flatly stated that the bear market is over. Meanwhile, nine top economists interviewed in U.S. News & World Report (March 2) talk about a mild to "mini" recession, but not one of them sees anything worse. Isn't it possible, therefore, that the market has seen and discounted the worst? Isn't it possible that the market is now ready to discount the coming boom just across the valley?

In my own view, this bear market is ultimately going to last longer, go far deeper and cause much more damage than anything the vast majority of investors or economists envision today. I don't doubt that the market may be building up for a rally and even a substantial rally from here. But I might remind my subscribers that unlike most services I do not advocate guessing at the end of primary bear markets, nor do I advocate playing for rallies and upward corrections in bear markets (such as the one we may now be starting).

As to the chances for this particular rally developing into a great rise, I am frankly doubtful. I stated in the last Letter that the odd-lot short sellers were noticeably



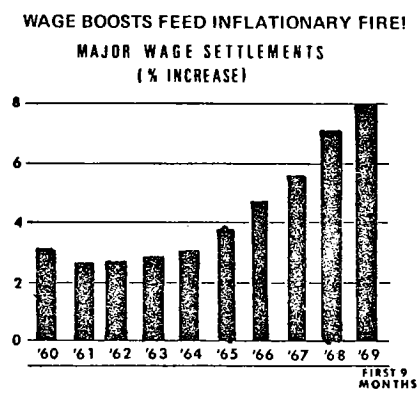


absent during January and February, a negative indication. And in this report I show that the short interest ratio for the 30 Dow stocks is in an unmistakable danger zone, a zone which has never been associated with a great advance. Furthermore, speculative sentiment, it seems to me, is still far too exuberant to suggest anything enormous on the upside.

so that's my position. I think that this rally, coming as it does in the second phase of the bear market, could well be a "fooler" as so many others have been. And I feel that we should stay with our policy of avoiding speculative and "scalping" plays as long as the primary trend is down.

It might help if we look at it this way. The most positive thing which can occur during a primary bear market is black pessimism (a sign of the end) and an almost universal reluctance to "ever touch a share of stock again." The further we are from that type of atmosphere, the less the odds that the bear market is near conclusion. Frankly, I don't get any feeling that Wall Street is anywhere near that kind of atmosphere. On the contrary, I believe that basic optimism is still the most widely-felt sentiment around. Optimism and the willingness to buy stocks are fine during a primary bull market. During a primary bear market they are simply indications that the primary forces have not fully expressed themselves.

AS 1970 UNFOLDS: At the Bal Harbor, Florida, meeting of the AFL-CIO, an 8-page report released by the union announced that fat wage increases were needed to offset inflation. The union needn't have bothered with their announcement, since it was well after the fact. This little chart (courtesy of Indicator Digest) shows what has been happening in major wage settlements since 1960. The direction is up and up.



In the meantime, the new figures for consumer prices jumped another .4% in January for an annualized climb of 4.8%. And seasonally adjusted, the climb was .6% or at a yearly rate of 7.2%, the same as the adjusted and unadjusted rate for December. Thus, if there is any progress in the fight against inflation, it is mainly in the area of "talk," not deeds. The real pressure is still on the Federal Reserve to clamp down on the economy, and the obvious implication of the statistics is that any loosening of the monetary strings will send the inflation indices skyrocketing.

Meanwhile, in a front page article in the Wall Street Journal (Feb. 20) the results of the bear market in stocks is documented. The upshot is that all over the nation individuals are calling off plans, cutting back on spending, putting off car and appliance purchases, losing jobs and boosting the unemployment lines.

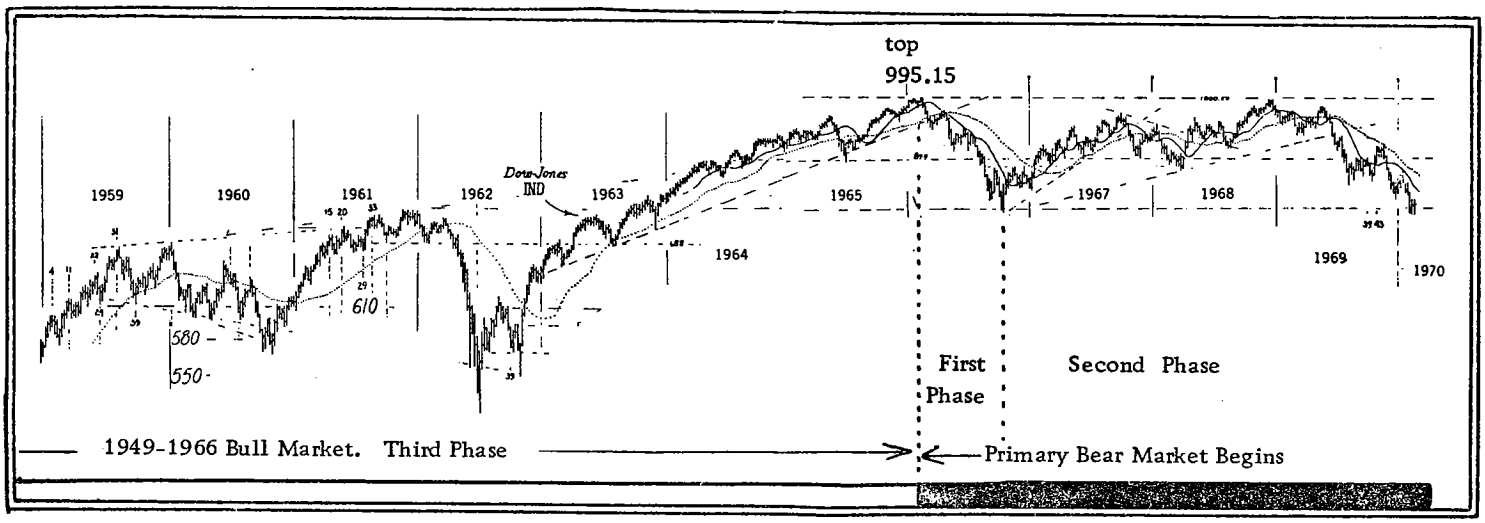
As sales slide off, inventories become an increasing problem. According to U.S. News & World Report (March 2), manufacturers' inventories are now the highest level in 25 months while retail inventories are the highest in 16 years. Obviously, sales will have to pick up or production is going to be cut back (which is now occurring). For example, as of February 1 the auto industry had a 75 day supply of new cars, the highest in history. Unless auto sales expand shortly (mid-February sales were down 18% over last year) there will be wide-spread factory closedowns as the auto makers scramble to get inventories into some sort of manageable condition.

Personally, I see the situation as a series of stages. The first stage is when inflation continues and business and labor boost prices and wages to offset the impact of inflation. The second stage is when the consumer (which includes labor) cuts back on spending since no quantity of wage boosts can succeed in offsetting the pains of inflation. This stage also sees corporations cutting back on expenses as inflation and cost of money hits their profits. The third stage is when business actually starts declining, and here profits collapse as costs and debt continue to eat into corporate profits, while actual business volume falls off.

The final stage is liquidation, panic and bankruptcies as profits vanish completely, cost cutting is rampant, and labor seeks jobs instead of pay increases. Nothing like the last stage has been seen in this nation in over a generation. I think it is coming.

PERSPECTIVE: "Hope springs eternal," runs the old aphorism, and perhaps that phrase applies to Wall Street 75% of the time. The other 25% sees Wall Street in the throes of primary bear markets, and of course when that happens "hope" can be a very costly and deceptive thing.

am publishing a chart on page 3 (from Quote Digest, 403 N. Main, Wichita, Kans. 67202) which I have arranged to show the end of the great 1949-66 bull market and the primary bear market from February, 1966 to date. A study of this chart should be instructive.



The third (or great speculative) phase of the bull market began from the 419.79 low of 1957. In many ways, this was the most unusual third phase of any primary bull market in history. It was extraordinary in that it lasted longer than either the first or second phases of the bull market and that it unfolded in three "sections." The first section was the rise from 1957 to January, 1960 (see chart). A correction followed, and the second section carried to late 1961. A drastic decline took the Dow to the 535.76 low of 1962, and after this clean-out the final section of the bull market's third phase carried the Dow to an historic peak of 995.15 (February, 1966).

Primary bear markets generally develop in three psychological phases (not to be confused with price movements). The first phase is the one in which stocks sell minus the froth and fury of the previous bull market's final speculative phase. The second phase of the bear market (the one we are now in) is the one in which stocks decline in response to deteriorating business conditions. The second phase usually brings in adverse social and political conditions as well. The third or final phase of a bear market sees stocks sliding below known values as depression and pessimism envelop Wall Street and Main Street. We would appear to be some distance (perhaps a year or so) from the beginning of any final phase.

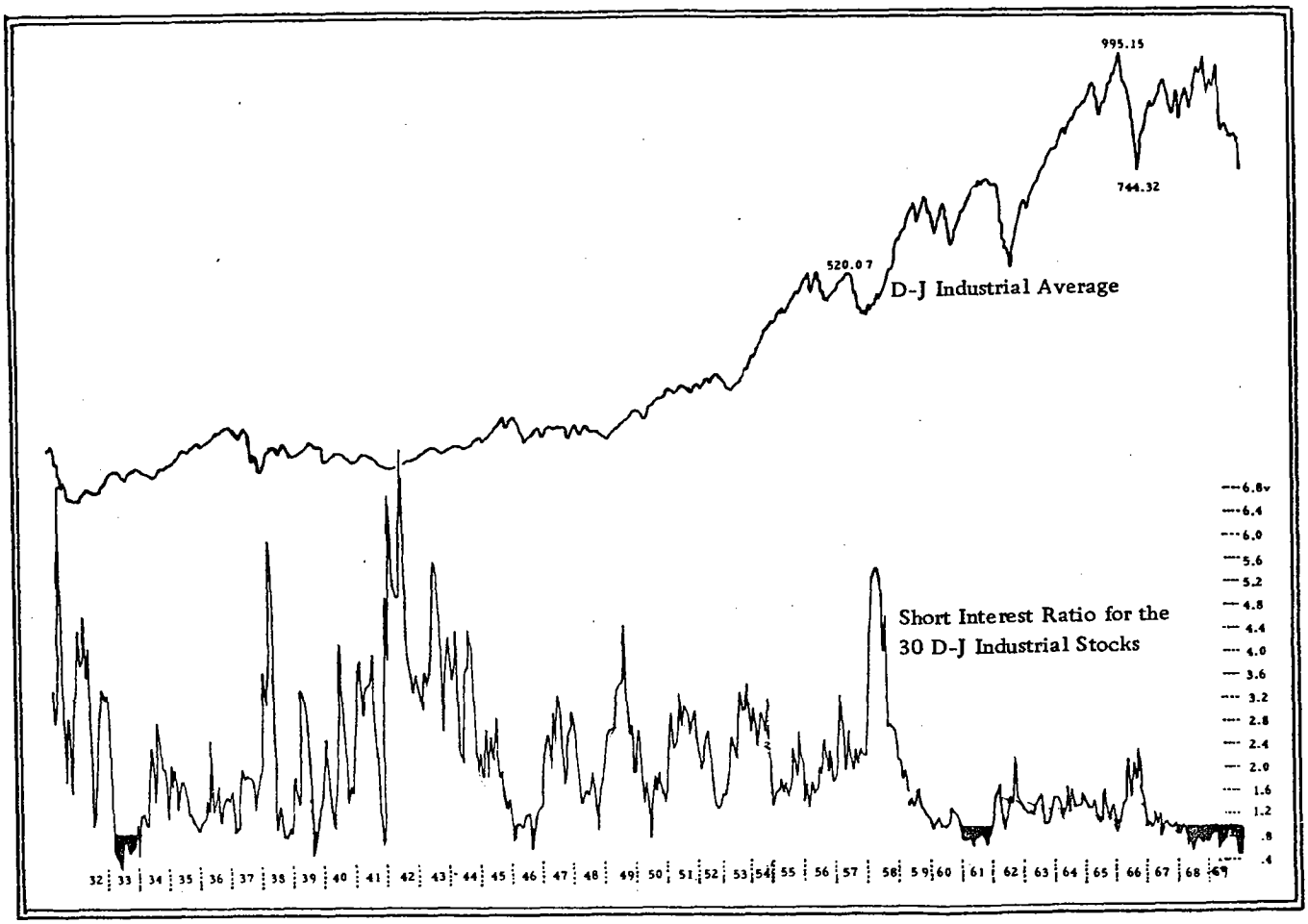
Now as to actual price movements during the first and currently unfolding second phase of the bear market. The first phase of the new primary bear market was short, unexpected and violent. Within eight months the Dow lost 251 points, closing on October 7, 1966, at 744.32. At this point the second phase was ready to begin. The second phase began with a major recovery movement. Spurred on by massive infusions of Federal Reserve credit, the remarkable upward correction took the Dow to a December, 1968 high of 985.21. Then the downward portion of the bear market's second phase started. By January 30, 1970, the Industrial Average succeeded in wiping out all of the 1966, 1967 and 1968 gains. The Dow on January 30 closed at 744.06, exactly 26¢ under the 1966 low close.

This takes us to the present. From the January 30 low, the Averages rallied again. And again many observers offered the opinion that the 744.06 low discounted the worst that could be seen ahead. Therefore, they reasoned, the bear market was over. I don't agree for a moment. As I have stated in Letter after Letter, major bear markets present certain signs and characteristics at or around their final bottoms. Some of these signs are black pessimism, high yields on quality stocks, a collapse of speculative interest, low volume (perhaps 10% of that which appeared at the highs), and "great values" in individual shares. I see none of these present today.

Traditionally, the second phase of a primary bear market is the most deceptive phase. So far, the second phase of this bear market has proved no exception. If I had to guess, I would guess that this second phase could end by wiping out all the gains in the Dow going back to around 1962. That could mean a terminus in the 500-550 area. Then the third or final phase would take the Dow to some "unbelievable and unexpected" low, perhaps in the 250 to 350 area.

DOW SHORT INTEREST RATIO: The ratio of the short interest in the 30 Dow Industrials stocks to their monthly trading volume is an indicator which I have watched ever since it was brought out by Bill Gordon of New York in Indicator Digest. I believe Dow Theory Letters is the only service in the nation which periodically publishes the historical chart of this valuable indicator.

The record of the D.S.I.R. is superior to that of the standard short interest ratio (which covers all stocks on the N.Y.S.E.) as a careful study of the chart on page 4 will show. Buy signals are given on the D.S.I.R. rarely, sell signals even more



rarely. Since 1932 there have been only three great or extended sell signals given by the D.S.I.R., and they are marked on the chart in black. These signals occurred when the D.S.I.R. dropped under the critical 1.0 level.

I just received the latest D.S.I.R. figure from Bill Gordon, and this shows the actual short interest through mid-February dropping from 547,000 to 500,000 in the 30 Dow stocks. This is the lowest total since September, 1962. At the same time the short interest ratio in the 30 Dow stocks sank from January's .55 to a .53 in February.

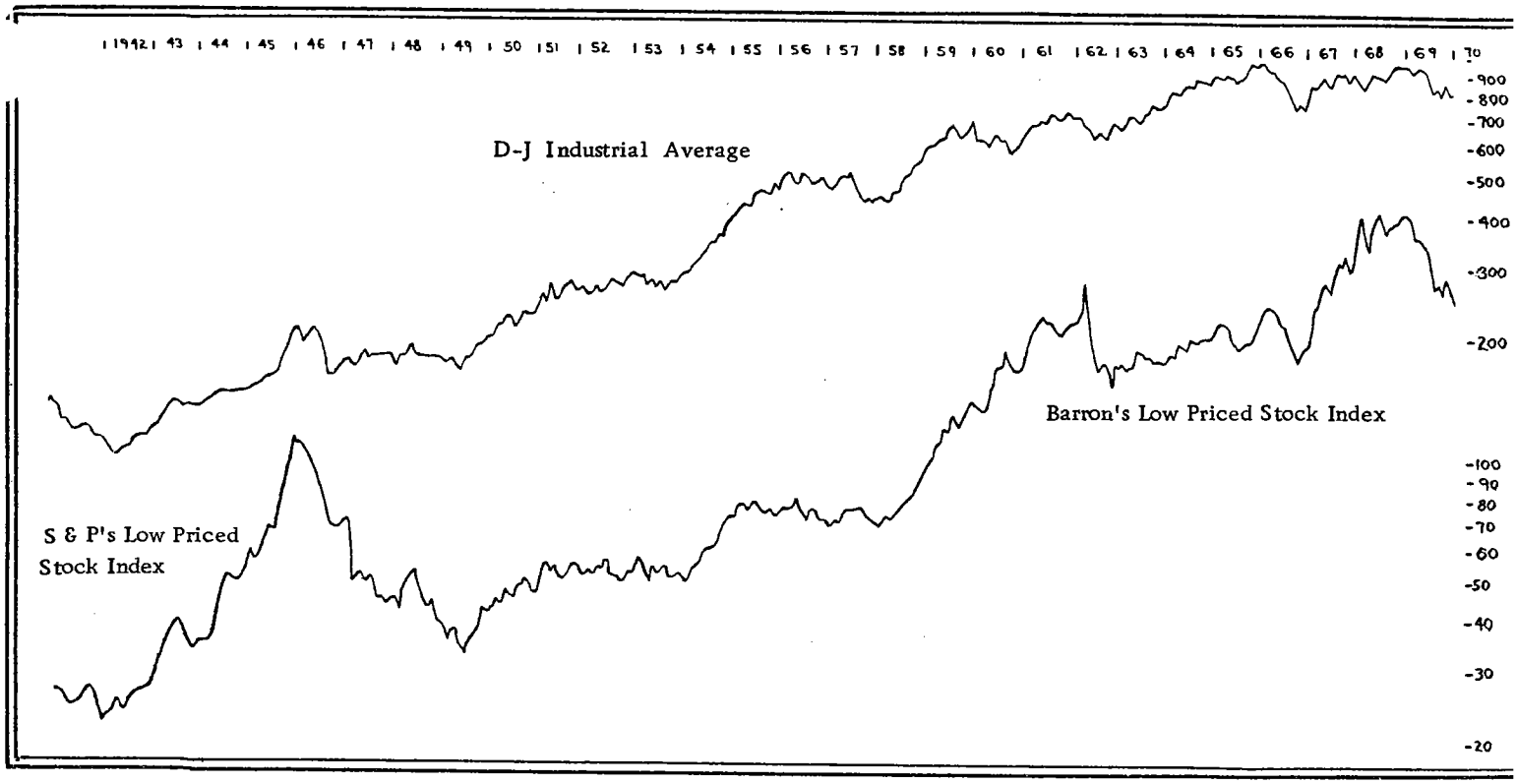
Thus, for 22 out of the last 24 months the D.S.I.R. has held under the 1.0 level, a record with no equal in the history of the indicator. Furthermore, the D.S.I.R. figures for the last four months (.58 in Nov., .74 in Dec., .55 in Jan., .53 in Feb.) are the four lowest consecutive figures in the history of the index going back to 1931.

A great many analysts expect a big rally or a "baby bull market" to develop from this area. I can only say that in the past no big move ever came with the D.S.I.R. in the .53 area. On the contrary, the 1932-37 bull market began with the D.S.I.R. over 6.0, the 1942-46 bull market began with the index over 7.0, the 1949-66 bull market began at over 4.4. The advance starting in 1953 showed the index over 3.0, the 1957 advance began with the index over 5.0, the 1962 and 1966 advances both started with the index over 2.0.

Now, with the index hovering at .53, I believe it is possible to get a rally, but to follow any rally from here would be to fly in the face of the 39-year record of the D.S.I.R. Never, in fact, has the D.S.I.R. ratio been flashing stronger warning signals.

SPECULATION: There are many ways of measuring speculative activity on the Exchanges. Many elaborate indices have been set up such as the ratio of volume on the N.Y.S.E. to the volume on the Amex, the average price of the most active stocks, the ratio of the low-priced stocks to the highest grade stocks, and so forth.

Personally, I prefer simplicity and a long history. I am including roughly three decades of the Low-Priced Stock Index, on page 5, together with the Dow Jones Industrial Average for comparison purposes. The L-P Stock Index is Barron's



L-P Index from 1947 to the present. For the period prior to 1947 I have used Standard & Poor's L-P Index (adjusted so that it correctly "joins" the Barron's Index). The chart is drawn to ratio scale so that the movements of the L-P Index and the D-J Industrials are shown as percentages of advance or decline. Thus the percentage movements of the two indices can be studied.

Note the huge percentage smash of the L-P Index during the 1946-49 bear market. This was a true L-P stock collapse, comparable in intensity to that which occurred in previous primary bear markets (such as 1929-32 or 1937). Note also the long duration of the collapse which began for L-P stocks in 1946. Although the whole Dow cave-in consumed only a few months, the L-P stocks continued down to a bottom formed three years later in 1949. The same phenomenon, by the way, occurred during 1937-42. The Dow took almost all of its beating during 1937, but the L-P Index continued down to a final low recorded in 1942.

Starting with the bull market's inception in 1949, we note that there has been no extended decline in L-P stocks. A sharp break did occur in 1962, but even here the entire loss in the L-P stock index occurred within a period of a few months.

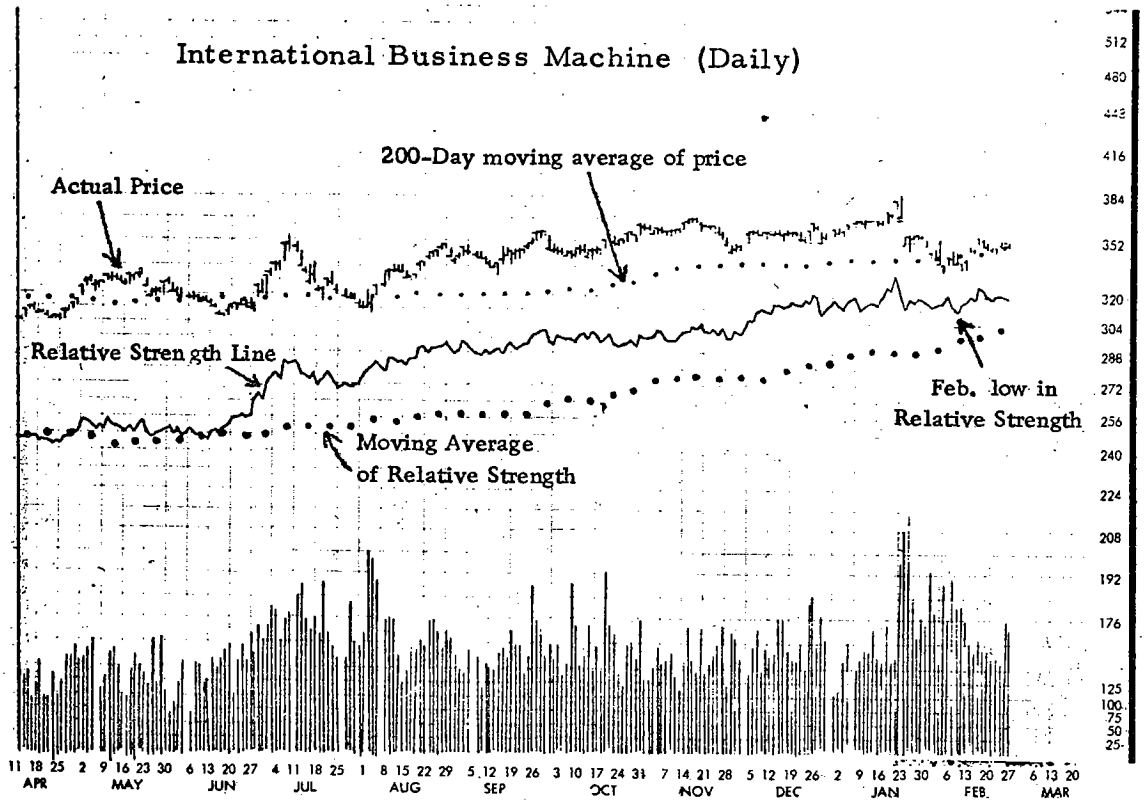
Following the 1966 all-time high for the Dow, the L-P Index sunk sharply, then pushed up to a new record high during 1968. During 1968-69, amid the extreme speculation which accompanied that bear market correction, the L-P stock Index formed a major top. Then during 1969 and early 1970 the L-P Index tumbled, losing about 38% of its value in a single year.

Nevertheless, I see the action since 1969 as only a minor downward "blip" in what should ultimately be an extended and severe collapse in the L-P Index. Based on past primary bear market action, I would say that the downside action in L-P stocks has just begun. It would not surprise me to see the decline in Barron's L-P Index extend into 1971 or 1972 with an eventual bottom below the 1958 low of 68. If this is correct, it would mean a further average price drop of around 75% for the majority of L-P stocks (the "cats-and-dogs") on the N.Y.S.E. and on the Amex.

DR. SZENT-GYORGI: I don't know why, but I was mulling over the fact that the U.S. has so far spent over $100 billion in Vietnam, and at the same time I was turning over the pages of the New York Times (Feb. 20). There I noticed that Dr. Szent-Gyorgi, the 76 year old discoverer of vitamin C and a Nobel price winner, is writing a new 40-page book. In an interview the Dr. stated, "Man is a very strange animal. In much of the world half the children go to bed hungry and we spend a trillion on rubbish—steel, iron, tanks. We are all criminals. There is an old Hungarian poem, 'If you are among brigands and you are silent, you are a brigand yourself.' "

Of his new book, "The Crazy Ape," the Dr. stated, "It is a revolutionary book because it is only 40 pages. There is nothing you cannot say in two hours if it is essential. I've given up writing for the old—you cannot convince them. You must give them time to die, that's all you can do. I try to write for young people— perhaps they will understand me."

All I can say is, "Put me down for a copy of your book, Doctor. When a man is 76, what has he got to lose by speaking the truth."



IBM: I include a daily chart from Traders Research, 101 Cherry St., Alton, Ill. 62002. I have been watching this leading stock with utmost interest, and as usual I have been particularly interested in its relative strength line. The R.S. line is the ratio of the stock price movement to the broad market (in this case the S & P 500 Index). One of the best ways to detect distribution or accumulation is by watching the trend of a stock's R.S.

Note that since April of 1969 the R.S. line in IBM has been moving up, regardless of all rallies or declines in the actual price of the stock. In other words, this leader has been acting consistently better than the market, and its early January, 1970, price was actually considerably higher than its January, 1969 price — no mean feat during this bear market.

Then a sharp break came in mid-January with the huge downside gap shown on the chart (the break was due, as everyone knows, to disappointing earnings). However, it is the R.S. line since that time that is interesting. Note the two lower peaks in R.S. Then last week IBM sank to the 340 range. I would guess that if IBM's R.S. line continues down a little further, to below the February low (arrow points to Feb. low), it would be a good indication that this bellwether stock had topped out. That, in itself, would be a phenomenon worth noting.

LATE NOTES: It really bothers me to analyze a market in terms of its reactions to "spot" news, but the February 26 jump of 13.86 points in the Dow bears discussion. Almost all of the 13.86 gain came after a late-afternoon announcement that the Lincoln National Bank (Philadelphia) lowered its prime rate from 8.5% to 8.0%. I did not find the Lincoln announcement particularly interesting, but what was interesting was the character of a market which could jump so violently on so flimsy a pretext. It seems to me that if there was any doubt of the highly speculative nature of today's Wall Street, the action of February 26 should dispel those doubts. Personally, I like a market that plows steadily upward on no news, not one that bounces up on rumors. Informed accumulation seldom comes on news which is available to everybody.